11 USC § 547(b)(1)
11 USC § 547(C)
Earmarking Doctrine

O'Connell & Goyak v. Watson BAP No. OR-91-2259-JAsR
Adv. No. 90-3131-S
In re Cox Bk No. 389-33596-S7

8/21/92 BAP aff'g DDS Unpublished

The BAP affirmed a judgment against the debtor's attorneys for recovery of a preferential transfer. The debtor's employer paid the lawyer's bill the day before the bankruptcy petition was filed. The panel analyzed the transaction and determined that the earmarking doctrine did not apply as argued by the defendant, because the debtor transferred collateral to secure the loan from his employer to pay the bill. Substitution of a secured debt for an unsecured debt does not fall within the earmarking doctrine because the transfer diminished the value of the estate.

The defendant did not meet it's burden of proof that the transfer was made in the ordinary course of business.

Affirmed by Ninth Circuit--unpublished Memorandum attached.

NOT FOR PUBLICATION

UNITED STATES BANKRUPTCY APPELLATE PANEL

OF THE NINTH CIRCUIT

In re:	BAP No. OR-91-2259-JAsR
David M. Cox,	BK. No. 389-33596-S7
Debtor.	Adv. No. 90-3131
O'CONNELL & GOYAK, A PARTNERSHIP LAW FIRM, Appellant,	
v.	MEMORANDUM
RONALD A. WATSON, TRUSTEE OF THE ESTATE OF DAVID M. COX, Appellee.	

Argued and Submitted on
July 24, 1992 at Portland, Oregon

Filed- AUG 21 1992

Appeal from the United States Bankruptcy Court
for the District of Oregon

Honorable Donald D. Sullivan, Presiding

Before: Jones, Ashland, and Russell, Bankruptcy Judges.

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BACKGROUND

On August 1, 1988, debtor David Cox ("Cox") received a $20,602.27 loan from Oregon First Investment Corp. ("OFIC") to pay a creditor, Dale Lewis. OFIC is owned by Cox's employer, Alan Nyman ("Nyman"). In return for the loan, Cox promised to transfer six (6) beach lots to OFIC. Cox failed to transfer the lots to OFIC, transferring them instead to his son, Timothy Cox. Timothy recorded the deed for the lots on May 5, 1989.

A year later, Nyman advised Cox to seek legal representation in an unrelated matter. Cox did so, incurring approximately $26,000.00 in legal fees. On August 6, 1989, Cox entered an agreement with his employer Northwest Fruit Marketing ("NFM") through Nyman, its owner. The agreement provided that in return for Cox's interest in contingent income tax refunds and for his interest in the previously mentioned beach lots, NFM would pay the legal fees. Because Cox was a signatory on NFM's account, Nyman gave him a blank check and told him to pay the legal fees with it. Cox did so, writing the check to O'Connell & Goyak ("O'Connell") for $25,931.69.

The next day, August 7, 1989, Cox filed a petition under Chapter 11 of the Bankruptcy Code.[1] O'Connell represented Cox in the bankruptcy case which was later converted to a Chapter 7 case. Appellee, the Chapter 7 bankruptcy trustee ("Trustee"), filed an adversary proceeding against O'Connell to avoid the

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[1] Unless otherwise indicated, all references to chapters and sections are to the Bankruptcy Code, 11 U.S.C. §§ 101-1330.

$25,931.69 transfer as preferential. The trial court ruled for the trustee, ordering O'Connell to pay the funds to the Trustee.

O'Connell appeals. We affirm.

ISSUES

I. Whether the trial court properly held that the earmarking doctrine does not apply to this transaction.

II. Whether the lower court properly held that O'Connell failed to establish ordinary course of business as a defense to the preference.

STANDARD OF REVIEW

Findings of fact are reviewed for clear error. Bankruptcy Rule 8013. In re Moreggia & Sons, Inc., 852 F.2d 1179, 1181 (9th Cir. 1988). Conclusions of law are reviewed de novo. In re Pizza of Hawaii, Inc., 761 F.2d 1374, 1377 (9th Cir. 1985).

DISCUSSION

I. **THE EARMARKING DOCTRINE**

A. PREFERENTIAL TRANSFER DEFINED

The trustee may avoid and recover transfers under several sections of the Bankruptcy Code. 11 U.S.C. § 550(a)(1). The requirements for a trustee's avoidance of a preferential transfer are found in 11 U.S.C. § 547. They are:

(1) A transfer by the debtor of an interest of the debtor in property;
(2) to or for the benefit of the creditor,
(3) for or on account of an antecedent debt,
(4) made while the debtor was insolvent,
(5) made on or within 90 days before the date of the filing of he petition, and
(6) is one that enables the creditor to receive more than the creditor would receive in a Chapter 7 liquidation if the transfer had not been made.

11 U.S.C. § 547(b). In order to prevail, the trustee must prove all of the above elements. 11 U.S.C. § 547(g). The parties do not dispute that the second through fifth elements are satisfied here. However, the same cannot be said for either the first or sixth elements.

With regard to the first argument, O'Connell contends that under the earmarking doctrine, the loan proceeds never became property of the debtor because the check was payable directly to O'Connell. The trial court disagreed. Because the parties have fully briefed the issue, we will analyze their respective positions. However, the better analysis may be to focus on the transfer of the debtor's interest in the tax refunds and the beach lots to NFM. That transfer was clearly made "for the benefit of" O'Connell, a creditor on an antecedent debt, even though the transfer was not made directly to O'Connell. See 11 U.S.C. § 547(b)(1). Under such an analysis, the earmarking doctrine is irrelevant.

B. THE EARMARKING DOCTRINE DEFINED

The earmarking doctrine is a judicially created interpretation of the first element of a preference--that the transfer involve "an interest of the debtor in property." In re Bohlen Enter., Ltd., 859 F.2d 561, 565 (8th Cir. 1988). Under the doctrine, when a third party advances or loans funds to the debtor for the specific purpose of paying another creditor, the funds never enter the estate or become property of the debtor. In re Sierra Steel, Inc., 96 B.R. 271, 274 (9th Cir. BAP 1989).

Under the earmarking doctrine, a transfer is not

preferential because transferring earmarked funds does not harm other creditors. One creditor is simply traded for another. See Coral Petroleum, Inc. v. Banque Paribas-London, 797 F.2d 1351, 1362 (5th Cir. 1986). In order for the earmarking doctrine to apply to a transaction, the transfer must satisfy three requirements:

> (1) the existence of an agreement between the new lender and the debtor that the new funds will be used to pay a specific antecedent debt,
> (2) a performance of that agreement according to its terms, and
> (3) the transaction viewed as a whole (including the transfer in of the new funds and the transfer out of the old creditor) does not result in any diminution of the estate.

Bohlen, 859 F.2d at 566 (footnote omitted).

C. APPLICATION TO THE CASE AT BAR

1. Agreement to Pay Antecedent Debt

In the case at bar, Cox entered an agreement with NFM on August 6, 1989, pursuant to which: (1) NFM agreed to loan Cox $25,931.69 to pay off O'Connell; (2) NFM agreed to assume Cox's miscellaneous personal debts totalling approximately $15,000.00; (3) Cox agreed to transfer to NFM his interest in tax refunds arising from a 1988 operating loss carryback of approximately $30,000.00; and (4) Cox agreed to transfer to NFM, his rights to the six aforementioned beach lots[2]. Thus, the first prong of the Bohlen test is satisfied in the instant case.

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[2] Cox had previously transferred the same lots to his son, Timothy Cox on April 29, 1989 by quitclaim, for "love and affection." The deed was recorded on May 5, 1989.

2. Performance of the Agreement

The second prong requires performance of the agreement according to its terms. In other words, the question becomes whether Cox used the funds as prescribed in the agreement. In re Van Huffel Tube Corp., 74 B.R. 579, 585 (Bankr. N.D. Ohio 1987). Cox paid O'Connell in accordance with the agreement. Therefore, this element is satisfied.

3. Diminution of the Estate

It appears that the third Bohlen element is not satisfied, however, because the estate suffered a diminution as a result of the August 6th transfer. The Trustee claims that because Cox was a signatory on NFM's account, and because he personally signed the check which was used to pay O'Connell, he controlled the transaction. The Trustee cites In re Hartley, 825 F.2d 1067, 1068, 1071 (6th Cir. 1987), for the proposition that if a debtor controls the payment from a new creditor to an old creditor, the funds become part of debtor's property. The Trustee submits that under this reasoning the funds at issue became the property of the estate. The Trustee points to Cox's admission that he was issued a blank check that he could have written to anyone.

The fortuity of Cox's signatory status, however, and the fact that he was given a blank check to sign does not seem paramount. These funds were transferred in accordance with the August 6th agreement. If the new creditor prescribes one method of payment (in this case, that Cox would sign the check over to O'Connell), and the debtor performs the agreement as prescribed,

the money never enters the estate. Van Huffel, 74 B.R. at 585. See also Grubb v. Gen. Contract Purchase Corp., 94 F.2d 70, 73 (2d Cir. 1938).

The Trustee is correct, however, in arguing that the security offered for the August 6th loan resulted in a diminution of the estate. To quote the trial court: "I decline to see any difference, other than metaphysical, between paying money directly to the firm or funneling it through a creditor who took estate property as security for the loan made to pay the law firm." The trial court correctly held that Cox controlled the transaction. Although neither party argued such, the key issue concerning diminution of the estate is the fact that the new loans were secured. The earmarking doctrine does not apply when an unsecured loan is paid through a secured guarantor. E.g., Van Huffel, 74 B.R. at 586. The debt owed to O'Connell was unsecured prior to the transfer. Moreover, Cox's admitted purpose in assigning the lots and the tax refund was to secure the debt with what little liquidity was available to him.

O'Connell argues that there was no diminution of the estate because Cox had already transferred the beach property to his son. However, as a result of an adversary proceeding filed against the son, the trustee gained a monetary judgment along with the remaining unsold lots from the younger Cox, having proven a fraudulent transfer. Viewing this, beneficial ownership of the lots and the money re-entered the estate and were thus transferrable to NFM as per the agreement. Therefore,

the transfer of lots to NFM reduced the estate as found by the trial court.

Moreover, Cox gave his right to the tax refund as security for the loan. The only evidence before the court regarding its value was the August 6th agreement which put the value at $30,000. While it is true that Cox had yet received the refund, this fact does not affect a finding regarding value.[3] Because the tax refund was offered and accepted as security, it possesses some value if only speculative.

Both the beach lots and the tax refund had value which was offered as security and/or consideration for the loan. The estate was diminished because Cox gave security for the agreement which satisfied an unsecured creditor. We therefore conclude that the earmarking doctrine does not apply in the instant case.

II. ORDINARY COURSE OF BUSINESS

O'Connell asserts that even if a prima facie case for preferential transfer is proven, the ordinary course of business exception applies here. The exception provides that the trustee may not avoid a transfer when the defendant shows that it was

> (A) in payment of a debt incurred by the debtor in the ordinary course of business or financial affairs of the debtor and the transferee;
> (B) made in the ordinary course of business or financial affairs of the debtor and the transferee; and
> (C) made according to ordinary business terms[.]

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[3] Counsel for the Trustee indicated at oral argument that the refund had been received.

11 U.S.C. § 547(c)(2). The purpose of the defense is to protect recurring, customary credit transactions that are incurred and paid in the ordinary course of business. Van Huffel, 74 B.R. at 588, citing H.R.Rep. No. 95-595, 95th Cong., 1st Sess., 373-374 (1977), U.S. Code Cong. & Admin. News 1978, pp. 5787, 6329, 6330. The case at bar does not display the type of business transaction envisioned by the framers of the Code because Cox had no prior dealings with O'Connell which would establish their ordinary course.

There is some authority for O'Connell's proposition that a history of prior dealings between themselves and Cox is not necessary. See In re Morren Meat & Poultry Co., Inc., 92 B.R. 737, 740 (Bankr. W.D. Mich. 1988). Although prior history would help establish the ordinary course, the absence of such does not preclude the court from determining the ordinary course. Id. However, this gloss on the ordinary course exception should not be applied here because the instant transaction is highly suspect. Cox paid his debt to O'Connell without ever having received a billing, or without knowing the amount owed. Further, O'Connell made no effort to show that this type of payment is ordinary to either their business or the industry, as required. We are not convinced that this type of payment satisfies the ordinary business terms requirement of 11 U.S.C. § 547(c)(2)(C). The trial court found that O'Connell failed to show the payment was made according to ordinary business. We agree and AFFIRM.

OFFICE OF THE CLERK
United States Bankruptcy Appellate Panel
of the Ninth Circuit

NOTICE OF ENTRY OF JUDGMENT

A separate Judgment was entered in this case on AUG 21 1992.

Motions for Rehearing

A motion for rehearing may be filed within 10 days after entry of the judgment. (Bankruptcy Rule 8015).

The motion shall be submitted on 8½ by 11 inch paper, shall not exceed 15 pages in length, and shall comply with rules governing service and signature. An original and three copies shall be filed.

A motion for rehearing may toll the time for filing a notice of appeal to the Court of Appeals. See Bankruptcy Rule 8015.

Bill of Costs

Bankruptcy Rule 8014 provides that costs on appeal shall be taxed by the Clerk of the Bankruptcy Court. Cost bills should be filed with the Clerk of the Bankruptcy Court from which the appeal was taken. Also see, Federal Rules of Appellate Procedure 39.

Issuance of the Mandate

The mandate, a certified copy of the judgment addressed to the Clerk of the Bankruptcy Court from which the appeal was taken, will be issued 21 days after entry of the judgment unless otherwise ordered by the Panel. A timely motion for rehearing will stay issuance of the mandate until 7 days after disposition of the motion, unless otherwise ordered. See Bankruptcy Rule 8017 and Federal Rules of Appellate Procedure 41.

Appeal to Court of Appeals

An appeal to the Ninth Circuit Court of Appeals is initiated by filing a notice of appeal with the Clerk of this Panel. The Notice of Appeal should be accompanied by payment of the $100 filing fee. Checks may be made payable to the U.S. Court of Appeals For The Ninth Circuit. See Federal Rules of Appellate Procedure 4 and the corresponding Rules of the United States Court of Appeals for the Ninth Circuit for specific time requirements.

(Cite as: 2 F.3d 1156, 1993 WL 302115 (9th Cir.))

NOTICE: THIS IS AN UNPUBLISHED OPINION.

(The Court's decision is referenced in a "Table of Decisions Without Reported Opinions" appearing in the Federal Reporter. Use FI CTA9 Rule 36-3 for rules regarding the citation of unpublished opinions.)

United States Court of Appeals, Ninth Circuit.

In re David M. COX, Debtor.
O'CONNELL & GOYAK, Appellant,
v.
Ronald A. WATSON, Appellee.

No. 92-36859.

Argued and Submitted July 14, 1993.
Decided Aug. 9, 1993.

Appeal from the Ninth Circuit Bankruptcy Appellate Panel, No. OR-91-2259- JAsR; Jones, Ashland and Rusell, Bankruptcy Judges.

Bkrtcy.App. 9

AFFIRMED.

Before: GOODWIN, FARRIS and THOMPSON, Circuit Judges.

MEMORANDUM [FN*]

****1** The judgment of the United States Bankruptcy Appellate Panel is affirmed for the reasons stated by that panel in its Memorandum Disposition filed August 21, 1992.

FN* This disposition is not appropriate for publication and may not be cited to or by the courts of this circuit except as provided by 9th Cir.R. 36-3.

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